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Lending Models -- How to Determine Why SME Loans are Made in Indonesia -- Moving Forward to a Research Agenda

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Lending Models -- How to Determine Why SME Loans are Made in Indonesia -- Moving Forward to a Research Agenda

What Does It Mean to Make a Loan

The giving of a loan typically requires a sequence of steps involving a number of parties. The steps include the following:

1. Exploration of alternatives by the borrower,
2. Marketing outreach by the lender,
3. Preliminary exploration and negotiation between borrower and lender,
4. Formal application, evaluation, and sanction by the lender, and
5. Disbursement by the lender and receipt by the borrower.

Who Makes a Loan

A number of parties are typically involved, actively and passively, in these steps. For the sake of simplicity especially in SME lending two actors are critical, the sanctioning officer and the applicant. In the case of SME or retail loans there is typically one sanctioning officer, though that officer may depend on the preparation of the loan file by a loan or credit officer, and there is one person who decides to apply, though the applicant may rely on advisers to prepare his loan materials and require the cooperation of various others in assembling the needed materials. Thus if a business license (izin usaha) is required the applicant needs the cooperation of the licensing authority in giving a license. If title papers for collateral real estate are required the applicant may have to get the cooperation of a clerk in the title record office.

For any given transaction, it should be possible to diagram all the cooperating agents needed and pinpoint the costs and limitations of using them. Roughly something of this sort has been done in the various studies The Asian Foundation and USAID have commissioned on the costs of getting a business license. Unfortunately, I am not conscious of anyone having commissioned similar studies for loans.

For small loans, on the sanctioning side the process is usually simpler -- not the least because most of the preparation burden can be transferred to the borrowing applicant. Thus the decision to sanction a small loan can usually be described simply in terms of the influences on the sanctioning officer. SME and retail loans in Indonesia in commercial banks are almost always sanctioned by one person, typically a branch manager or in some cases a regional manager. There should be banks in which such loans are sanctioned by the line loan officers themselves, but I have not located any. There are probably banks in which loans are only sanctioned by the head office -- but these are either very small or do not do significant small scale business. These sanctioning officers typically have the authority to sanction loans of up to 1-3 billion rupiah, under standard terms and conditions prescribed by the banks.

The logic of a single sanctioning officer for small loans is the considerable cost that a more elaborate process would entail, as well as the fact that small, retail loans are typically so intertwined with the other business of a bank branch -- gathering deposits, making remittances, collecting and paying bills, and providing fee based services -- that it may prove difficult to disentangle them.

How Do they Make Loans

In a number of cases, the standard terms and conditions for SME/Retail loans are publicly advertised, but in any case they are ostensibly standard. In fact, there is usually some room for discretion in precise interpretation as in the evaluation of collateral. There are often non-standard conditions imposed by each sanctioning officer, and occasionally additional fees and charges exacted sometimes for the sanctioning officer personally. The sanctioning of loans is typically subject to a lending budget limit -- on the total amounts of such loans disbursed. However, I am told that this is rarely an operational constraint because sanctioning officers rarely get close to their authorized limits.

As with studies of the steps, actors, and costs involved in the process I am not conscious of any systematic study of the deviation of actual terms and conditions from the normal lending package. The Ministry of Cooperatives and Small Enterprise has attempted a cataloguing of the published standard terms and conditions under which commercial banks lend to SME, but they inform me that it has proved difficult to secure cooperation.

What Determines Their Amount

The amount of small loans made is a thus a function of how many loans the authorized officers sanction. The rates and conditions are usually standard. The prime determinants of how many loans are made are probably the following:

1. The demand for such loans at the set terms and conditions
2. The incentives the sanctioning officers have to make and not make such loans.

   The incentives and disincentives can be direct -- targets for small loans, penalties for small loans in arrears etc. -- all items which are typically used in the routine personnel evaluation and promotion system of the bank concerned.

   But they can be indirect -- effects on the bank branch's overall business (returns, deposit mobilization) or effects on the branch managers relation with supervisors and the local community.

The study of the bank lending process is one where the different factors which affect the lending process are quantified, at least in an ordinal if not cardinal form.

These factors, unfortunately, are both conscious and expressed and subconscious and unexpressed. In other words, it is necessary to interview sanctioning officers about what they think influences them, and to study their actual decisions and how they fit with the sanctioning officers' self-analysis. Nonetheless, it should be possible to formulate some hypotheses and test them. Among the key hypotheses to address are as follows:

> 1. If few loan applications are refused or withdrawn it seems probable that demand, at current terms and conditions, is the major determinant of lending. Application withdrawals are critical and hard to monitor, because once it is clear that a loan will not be approved, the application for it is frequently withdrawn. The research problem -- is that withdrawal is often an informal and undefined process, as distinct from sanction and denial. The only way out I can imagine is to correlate reports from loan officers with those from small entrepreneurs.
>
> 2. If there are few career rewards for SME lending or severe sanctions for lending that fails, it can be hypothesized that this is a major contributing factor to low levels of lending. This hypothesis could be tested by correlating incentive systems and levels of lending.
>
> 3. If the lending authority of sanctioning officers is also constrained, those constraints should also play some part in governing levels of lending. Again, some correlation between the degree of constraint and lending is to be expected.
>
> 4. Finally, it can be expected that informal social pressure within the banks and local community will also influence lending levels. This can perhaps be tested primarily through attitude surveys of loan officers.

All of these factors act after the constraining effect of more formal constraints -- the levels of interest and the quality of collateral demanded, the requirements for licenses and documentation etc.

Previous work on SME lending in Indonesia has concentrated on these formal lending constraints, but I suspect that the incentive and demand factors mentioned above are likely to be those which influence observed changes of levels of SME lending. This is especially in the case of banks other than those like BRI, Bukopin, the Provincial Development Banks, the bulk of whose business is SME lending.

Summary of A Research Agenda

Research on the factors that govern bank SME lending should thus cover the following points:

1. Who can sanction small loans (SME/Retail), up to what amounts, and under what terms and conditions?
2. What volume of such loans are applied for and either sanctioned, denied or withdrawn? [The latter is a particularly difficult point]
3. What career or direct incentives are provided bank sanctioning officers to make or not to make such loans?
4. What other pressures affect bank sanctioning officers in making such loans?

5. What are the prescribed terms and conditions for SME/Retail loans, and to what extent are they adhered to?
6. Which of these terms and conditions in fact result in small loans not being given?

Most of the information above is obtainable by asking the bank's head office for their rules, regulations, and instructions about such small loans. A smaller number might be helped by a survey of selected sanctioning officers themselves. Finally, some can only be elucidated by explicit case studies of loans as they are made.

The results of the investigation proposed then needs to be correlated with the volume of bank SME/Retail lending, defined variously as under 350 or 500 million Rps, or 1-5 billion Rps. The correlations produced would then identify the factors actually governing SME/Retail lending and suggest how they might be influenced.